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SUBJECT: Belgian Regions and Federal Taxes - Paying
For Political Devolution In Belgium

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¶1. (SBU) Summary. The "good news" story of Belgian federal fiscal management is less lustrous than it appears. Ongoing devolution of responsibilities from the federal to the regional level since 1993 has created growing pressure by the regions for more revenue to perform their tasks, but taxing remains dominantly a federal purview. Transfer of responsibility for any major component of Belgium's social safety net as a result of post-election federal-regional negotiations would necessitate a major revision of tax apportionment in Belgium. End Summary.

Less Healthy Than It Appears?

¶2. (U) As the Belgian federal election on June 10 nears, review of eight years of Prime Minister Guy Verhofstadt's budgets reveals a tradition of balanced budgets that mask long-term indebtedness, delayed repayments, and eroding financial balances. Much of this has been driven by fiscal pressure from the three regions that comprise Belgium: Flanders, Wallonia and Brussels. Since the 1988 Constitutional reforms that created the Belgian Federal state, the regions have gained authority through the devolution of considerable responsibilities from the federal government to regions, language communities, or lower. The revenues to fund these growing responsibilities has come largely from transfers from federal tax revenues. How to fund the budgets necessary to sustain any further transfer of responsibilities to the regions is a crucial question. The existing tax distribution structure may come under increasing pressure if devolution is deepened in the post-election negotiations, as many expect.

¶3. (SBU) Since 1999, Verhofstadt has made fiscal discipline his hallmark, passing a string of balanced, or even slightly surplus, budgets. Facing towering public debt of 113 percent of GDP when he entered office in 1999, Verhofstadt brought it down to 87 percent of GDP this year ? an impressive record hailed by both the OECD and the IMF. In eight years Verhofstadt worked to cut taxes, keep interest rates low, and promote investment; he achieved Belgian GDP

growth exceeding the EU average in most years. Aware of the aging population and the problem it will pose to Belgium's generous welfare state, Verhofstadt also structured a surplus to feed a "Silver Fund" that by the end of 2007 is supposed to reach a value of 15 billion euros. The low interest rates, courtesy of the European Central Bank, which lowered Belgium's interest payments, yielded a small primary surplus that Verhofstadt could spend on police reforms and subsidies for Belgian post, railways and Sabena airlines.

14. (U) The flip side of this shiny coin is a more tarnished reality. Some years the budget balance was achieved through a variety of questionable one-off actions: a fiscal amnesty to repatriate billions in capital that had fled the high-tax country; the sale and lease-back of hundreds of government properties at year-end to create positive cashflow; the absorption of pension funds from quasi-public entities to cover twelfth hour revenue shortfalls; and pushing payments due by the government into the next fiscal year. According to Belgium's Cour des Comptes (GAO equivalent), these actions added 800 million Euros to the 2007 budget. Many of these actions imply long-term recurrent expenses to the treasury, such as rents and pension obligations in outyears. Most troubling to financial analysts, Belgium's primary balance, the surplus of revenues over expenses before interest payments - a litmus test of government economic health, has declined from 7 percent in 2000 to 4.1 percent in 2006. This is reportedly the sharpest decline within the Eurozone, during the period when most other EU countries realized stable or improving primary surpluses. The government also demanded

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"contributions" from the private sector to finance new projects or to cover budget shortfalls, the pharmaceutical and energy sectors are cases in point.

15. (SBU) The watchdog of federal finances, the High Finance Council, is slated to present an assessment of federal financial management over recent years after the June 10 election. Delayed release is seen as political favoritism by opponents of the present government. The High Finance Council is headed by the Deputy Governor of the Belgian central bank (BNB), Luc Coene (a former Chief of staff of Verhofstadt), and consists of previous ministers and academics of party affiliations sympathetic to the liberals (VLD and MR).

Regional Responsibilities and Budgets Growing

16. (U) Federal government transfers to the regional governments are an important reason for the decline in the primary balance, the government claims. Transfers to the regions and linguistic communities regularly exceed budgeted amounts. These sub-national entities are anxious to take on more responsibilities, arguing for the location of public policy decision-making closer to the citizens being served. This shift of power may well have kept Belgium a single federated country and kept social peace since the wave of Flemish nationalism in the 1980s. Regions are now responsible for agricultural policy, environmental regulation and oversight, foreign trade promotion, export control and licensing, and economic development. The linguistic communities control of education, cultural affairs, and family policy. Post-election federal-regional negotiations will consider granting the regions authority over employment insurance, health care and labor policy, which could have deep implications for Belgian federalism.

17. (U) In contrast to the devolution trend, however,

taxing authority is one competence that has not been deeply regionalized. The bulk of tax revenues are still paid to the federal government. Regions and communities are permitted specific taxes (inheritance, car registration, gambling, media/entertainment) that add up to only 12 percent of total Belgian tax revenues. A tax sharing agreement which dates from the early 1980s apportions to the regions the rest of their operational income. While constitutional reforms in 1993 enhanced the regional share, the regions complain they need more resources. From 2000 to 2006, Belgian regional and community spending has increased from 1.4 to 5.6 percent annually, averaging 3.5 percent growth each year. In 2005 this totaled 34.5 billion Euros, equal to 32 percent of the total Federal budget's disbursements.

¶8. (U) The rising demand for regional budgetary resources has been met in part by the regions themselves. Strong economic growth in Flanders has yielded higher receipts for the region in its narrow taxing authority. As a result, Flemish authorities have been able to keep balanced or slightly positive budgets, and paid down their regional public debt from 2.5 billion Euro in 2000 to less than 480 million Euros by 2006, and they expect to nearly retire it by ¶2008. Brussels Capital region has seen its public debt shrink by two-thirds from 2000-2006. In the less economically dynamic Walloon region, however, deficit financing has had to cover increasing public disbursements, and Walloon public debt rose from 2.1 to 3.6 billion Euros over the same period.

Take the Job Without the Money?

¶9. (SBU) The differences between the regions in terms of economic health, industrial composition, and fiscal management have made budget issues a lightning rod for regional politicians this election. A Flemish study of 2006 claims Flanders subsidizes Wallonia to the tune of 6.5 percent of Flemish regional GDP annually, over 10 billion Euros. This supports sentiment in the north of Belgium to ask for further devolution of responsibility such as healthcare, childcare

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allowances, pensions and unemployment benefits to the regions ? and the share of federal budget to pay for them. Walloon politicians, while denying that a Flemish subsidy exists, are reluctant to risk losing the deep federal pockets that cover the high unemployment and social service costs of their region. The federal government spent almost 210 billion Euros on social security and healthcare in 2005, one-fifth of the federal budget. If transfer of any major component of Belgium's social safety net is attempted during the post-election federal-regional negotiations, it would necessitate a major revision of tax apportionment in Belgium.

Comment

¶10. (SBU) Revising the federal-regional tax structure at the same time as governance competencies are redistributed would be logical, but may be less popular in Wallonia than in Flanders, despite demands by all regional leaders for more revenue. Comfortable with their regional economic strength and fiscal management, Flemish politicians would welcome the independent authority and funding to execute it. In Wallonia, still buried in public employment scandals (Ref C), 18 percent unemployment, and weak budget discipline, party leaders may be loathe to take on major responsibilities ? and accountability -- without the fallback of federal coffers. Whether the federal fiscal problems can fully be blamed on regional

demands is questionable, since allocation of tax revenues to the regions was part and parcel of the constitutional reforms of 1988, 1992 and 1993. What is beyond question is that raligning tax revenues with the distribution of competencies in Belgium is a messy job awaiting the new government.

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